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SIPDIS

STATE FOR EUR/NB (MGERMANO) AND EB/IFD

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TAGS: EINV ECON LH
SUBJECT: IMF'S RECOMMENDATIONS ON HOW TO PROLONG THE LITHUANIAN ECONOMIC MIRACLE

SUMMARY

¶1. An IMF delegation, concluding an Article IV Consultation mission to Lithuania December 10, praised Lithuania's impressive structural improvements and the country's complete transition to a market economy. The IMF delivered an overall positive assessment of the country's economic prospects for 2005 and several short-term policy prescriptions to ensure continued growth. The IMF delegation warned that the economy risks overheating, however, and also advised attention to remaining fiscal and other structural reforms. Congratulating the GOL on the economy's performance, the mission was optimistic that Lithuania would speedily adopt the euro and attain the living standards of more advanced European countries. The IMF's policy prescriptions provide an agenda for the new GOL's Ministry of Finance and guideposts for our advocacy and reporting of their progress. End Summary.

¶2. An IMF delegation under the leadership of the Fund's European Department Assistant Director Ashoka Mody concluded an Article IV consultation on December 10. The mission's overall analysis lauded Lithuania's structural reforms. The delegation congratulated the GOL on the economy's strong performance since the last IMF consultation in June 2003, Lithuania's accession to the EU, and the country's entry into the ERM-II currency mechanism. The mission noted Lithuania's continued robust, non-inflationary growth in 2004, declining unemployment, and predicted GDP growth of 6.5 percent in 2005, and annual growth of five to six percent in the medium term.

IS LITHUANIA OVERHEATING?

¶3. The IMF cautioned that Lithuania's fast growth rates would stimulate aggregate demand to grow above potential, leading either to destabilizing inflation or greater borrowing, with higher current account deficits and external debt. They noted that inflation, expected to be just under 1.5 percent in 2004, will likely exceed 2.5 percent in 2005, and remarked several early signs that point to a risk of overheating of the Lithuanian economy:

- High capacity utilization;
- Continued robust growth of credit, driven by low interest rates;
- Declining unemployment;
- Acceleration in wage growth;
- Increases in property prices;
- Rapid growth in the current account deficit; and
- Output exceeding potential.

The mission stated that supply-side shocks are exerting inflationary pressures, noting that recent increases in oil prices had raised domestic prices because of the high energy-intensity of Lithuania's production. It noted, however, that domestic demand is equally inflationary, pointing to the sharp increase in real estate prices, and added that there is a continuing risk of price increases in utilities and other non-traded goods.

URGES TWO PERCENT FISCAL DEFICIT TARGET

¶4. The IMF noted that Lithuania's current account deficit has widened sharply. The mission recommended the GOL closely monitor external debt obligations, take measures to raise the private savings rate, and reduce the fiscal deficit, since the latter contributes significantly to the demand pressures underlying the current account deficit.

¶5. Commending the GOL for accepting the fiscal discipline of the Maastricht criteria in order to achieve early adoption of the euro, the mission encouraged the GOL to adopt an even more ambitious fiscal deficit target for 2005 of two percent of GDP, rather than the current 2.5 percent target. It suggested the GOL could reduce the fiscal

deficit by taking advantage of the high projected revenue in 2004 and transferring domestic co-financing funds to 2005, since these will not be needed in 2004 due to the delay in the utilization of EU funds. The mission observed that a conservative fiscal policy would prevent overheating, while allowing the GOL the flexibility to increase the deficit in the future in order to stimulate demand, should domestic confidence fall unexpectedly.

URGENT: REFORMS TO ENSURE LONG-TERM GROWTH

¶6. The IMF urged the GOL to implement fiscal and other structural reforms to ensure a stable revenue base and create incentives for private entrepreneurs to increase employment, invest in upgrading the quality of the labor force, and better enable their enterprises to compete against lower-wage economies in international markets. The mission recommended the following reforms:

- More effective collection of VAT revenues to remedy the shortfall in 2004, and reforming the VAT tax administration system;

- A significantly lower and unified single personal income tax rate that would maintain the current exemption threshold and would be appropriately phased in to limit disruption to revenues, along with greater efforts at achieving tax compliance;
- Institution of a more wide-ranging property tax, to both increase revenues and provide incentives to municipalities to invest in education, infrastructure, and public services;

- Greater transparency and control in the design and management of public expenditures, to include detailed documentation of government expenditures and cash flows, identification of buffers to deal with contingencies, and institution of modern cash control methodology;

- a more financially viable social security system featuring accelerating increases in the retirement age;

- Expansion of the social safety net, by devising a means-tested targeting system for income support, but not by raising the minimum wage, since the latter is already high relative to other countries and a further increase would only serve to discourage employment;

- Introduction of a Fiscal Responsibility Act in parliament which would contain GOL commitments to targets, procedures, and transparency of budget revenues, expenditures and debt, and would provide a comprehensive and transparent framework to ensure long-term fiscal reforms; and

- Additional microeconomic reforms to increase the attractiveness of Lithuania's business environment, such as decreasing complex and time-consuming regulations facing small and medium enterprises, increasing private initiatives in the health and education sectors, and implementing World Bank recommendations on the knowledge economy.

The mission concluded that a GOL focus on these short-term policy prescriptions would ensure early adoption of the euro and rapid improvement of living standards to match those of more advanced European countries.

COMMENT

¶7. The IMF prescriptions are timely, coming just as a new Government takes office. The IMF framed the challenge well: Lithuanian elites must now decide how quickly Lithuanian income levels will converge with those in Western Europe. To catch up quickly, this Government and Parliament will have to forget about the populist platforms that helped elect many of them and adhere instead to the IMF's recommendations.

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